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ABSTRACT

Two papers consider state regulation of the telecommunications industry. The first paper, "Managing the Mixed Bag: Incentive Regulation at the State Level" (Gail Garfield Schwartz, Deputy Chairman, New York State Public Service Commission), describes New York State's regulatory policies in the broader context of the best ways for state regulators to address the problems caused by a growing and changing, yet still basically monopolistic telecommunications industry. It is noted that in New York, rate stability plans are in place which encourage the cutting of operating costs through higher rates of return. The second paper, "The Information Age--Leader or Follower" (Bailey M. Geeslin) (abstract only) argues that the traditional base rate of return regulation is not compatible with the enormous changes which have occurred recently in the telecommunications sector, including technological advances, significant governmental decisions, and competition in the industry. Changes in the regulatory structure are recommended to keep this nation from becoming a second-rate information based society. (Author/EW)

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MANAGING THE MIXED BAG : INCENTIVE REGULATION AT THE STATE LEVEL

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PAPER PRESENTED TO AIRLIE HOUSE CONFERENCE

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"PERMISSION TO REPRODUCE THIS MATERIAL HAS BEEN GRANTED BY

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The problem of state regulators is expressed in the old story about the two hikers in the deep forest. They are resting, shoes off, by a lake when a grizzly comes lumbering out of the woods. One hiker grabs his shoes and shoves his feet into them. The other says, "Are you crazy? You can't outrun a grizzly!" "I know," says his pal. "All I have to do is outrun you."

Advanced telecommunications systems are the quintessential underpinnings of the modern economy. And we state regulators are fast hikers in the woods, following the moss on the trees in hopes of getting to a clearing where we'll have the best of all worlds: high quality hi-speed services for business, low price for captive residential ratepayers, and no grizzlies in the form of monopoly abuses.

Our guiding stars should be these two fundamental truths.

Fundamental truth #1: There is no such thing as perfect regulation.

Fundamental truth #2: There is no such thing as perfect competition.

The policy issue therefore is:

What costs arise from imperfect regulation?

Whom do they fall on?

What costs arise from imperfect competition?

Whom do they fall on?

In New York we are pursuing a policy of incentive regulation which is designed to minimize the costs of imperfection. Many proceedings

have led to the Commission decisions that, cumulatively, implement this policy. Specifically, the objectives are to:

- move prices towards appropriate costs.
- assure universal service, even for those of lowest income.
- encourage the telcos to market existing services and devise new services and packages of services.
- promote economic efficiency.
- assure the maintenance of high quality standards, and
- leave doors open to competitors wherever they choose to enter the market.

Not a small task. But not a prohibitively difficult one, either. It begins with the premise that we are dealing with a largely monopoly industry that is nevertheless challenged in key, lucrative markets by competition. That's why I call it managing the mixed economic bag. It involves sharing risk and reward.

This is the mixed bag. For the foreseeable future, the telecommunications sector will be rooted in monopoly network services. Opportunities for competitive services related to network services will grow, but it is not clear how fast. Opportunities to compete via bypass will remain attractive to some large private networks, but it is not clear to what extent they will pursue them. The long-distance companies and future hybrids formed by mergers of computer manufacturers, systems designers and common carriers will

look to provide end-to-end services for large business customers. These companies may also try to serve select medium-sized businesses and high-income residential consumers; at present, these markets are more secure for local exchange carriers (LECs), if they provide the right services at the right prices.

The LECs still retain control of the bottleneck of the interconnected telecommunications network, the central office switch. As long as that is the case, the LECs can exercise monopoly power. The network will retain a competitive economic advantage for a long time to come, even if substitute services grow rapidly, in that it will still show declining costs with the addition of subscribers.[1]

In a perfect world, the price for each telecommunications service would not exceed the cost of that service (including a reasonable profit). This would mean the elimination of cross subsidies, and would, of course, mean that POTs and universal service are more expensive.

But in the imperfect reality, regulators will not be able to achieve their economic base objectives if consumer advocates and elected officials perceive a danger to "affordable" universal service. Therefore, one has to accept the notion that basic telephone service will be subsidized for income qualified subscribers. The question is, do we subsidize both usage and access? There are good economic

arguments in favor of subsidizing only access, including installation charges. But people's real needs may not be met. The subsidy of usage up to a limit is a preferable approach.

The point about universal service is that it is one of several goals. Rather than argue about it, it's best to just provide it, in a form that's really valuable, and worry about what it costs when we know what it costs. (Even if cost-based pricing were the regulator's sole objective, there are no reliable service-based measures of these costs.)

The technique is to guarantee universal basic service in a way that limits the potential cost of the subsidy, and as a trade-off allow flexible pricing for discretionary services. Ultimately when there is competition in the discretionary services, their prices will find their competitive level. If efficiencies can be introduced in the interim, the loss of cross subsidies to basic service from discretionary services will not be a problem. The telephone companies should be encouraged by the promise of higher earnings to repackage service offerings, market them creatively, and to offer new service providers opportunities for using the network.

It is the presence of or potential for competition in discretionary services that allows the shift from cost-plus rate of return regulation (RORR) to price-quality regulation. The shift is away from a system that ignores the relation between service costs and service price towards a system that encourages both lower prices and

lower costs. The lower costs are encouraged by rewarding LECs for productivity gains. The reward comes in the form of larger allowed profit margins. The trade-off that must be obtained from the LEC is a commitment not to achieve these higher earnings at the expense of captive, basic-service ratepayers, but rather, to earn them by new sales and new productivity.

The way we have done this in New York is through rate stability plans, and we were the first in the nation to adopt them. In 1985, we negotiated a moratorium on general rate increases with New York Telephone Company. The company's allowed rate of return (ROR) was set so it would have an incentive to cut operating costs so that it could earn the maximum. One-half of the earnings over a set boundary would be kept by the company. We proposed in early 1987 to extend that moratorium, and to depreciate, during the extension period, the capital costs associated with inside wire. The price of basic service could be reduced during the period because the company would realize windfall earnings as a result of the federal tax reform act (TRA 86) and because the actual costs of capital were falling. The previously allowed ROR was retained as an incentive and again, one-half of the earnings over a limit agreed to by interested parties could be kept by the company.

Universal service is supported via a three part lifeline offering. Whereas previously our lifeline service consisted of discounts on any of the service options, now it has three elements. Dial tone will cost $1. Basic Service offers a 10 percent discount on all intralata calls, up to a maximum of $5. An Expanded Usage Package (EUP) offers the 10 percent discount, up to $10 worth of usage, including interlata toll, for a prepaid $10. The guaranteed revenue stream of the prepaid offering will protect other customers of New York Tel against undue losses from the new lifeline service. The EUP is nothing less than a new definition of essential service. AT&T has agreed to provide a 5% discount on its intrastate charges. Staff have had conversations with the FCC staff and AT&T, and we hope to engineer an agreement with AT&T to offer a similar discount on lifeline toll interstate. We hope that other carriers will discount toll.

Other companies in New York have also entered into rate stability plans. We expect that these and other telcos will emulate the life line service voluntarily.

The usage subsidies are bolstered by connection subsidies and utilize the FCC "Link-UP America" Discount.

The NY Tel rate design decision provided for a reduction in rates of about $115 million, of which the lifeline elements account for $6 million. We also reduced private line rates by $10 million. We also

approved a regional calling plan for downstate, which expanded non-toll calling areas, worth $59 million in rate reductions, and gave upstate customers parity reductions. We reduced service connection charges for all customers.

To fund these and other minor reductions in addition to the $100 million stipulated rate reduction, we allowed the company to raise rates for dial-it services, and to increase the fees to dial-it vendors. We imputed $15 million in revenues from such services, but we asked the company to propose a method of sharing profits that would substitute for revenue imputations. During my review of testimony on dial-it services I began to conjecture that a method akin to a commercial lease agreement--that is, a base rental against a percent of gross revenues--would be a very useful regulatory arrangement. It would augment the incentive for the company to encourage usage through vendor-provided information services, while protecting captive rate-payers against the possibility that competition will drive down rates for those discretionary services that are subsidizing basic services.

The ultimate success of our incentive regulation will depend on quality of service. The management of NY Tel seems to agree that they and we will suffer if service quality deteriorates. It should, hopefully, improve. The Commission has made clear its intention to monitor service more closely than ever before.

I think that our approach reflects a conviction that deregulation will not alone create competition, at least not sustainable competition. When our current generic competition proceeding is complete, we may have a better grasp of how much additional competition is likely to materialize, when, and under what sets of prices and other circumstances. I certainly do not, personally, believe that competition has to be exactly duplicative to induce lighter regulation, or deregulation. What I do believe, however, is that a sustainable market presence in comparably valuable and efficient services by competitors is the prerequisite for deregulation.

Base-plus-percent-of-gross is an approach that also might lend itself to proper pricing of access for enhanced service providers, including the BOCs themselves, when Judge Greene can be convinced that safeguards against monopoly abuse are adequate.

Looking to the future, the goal for both regulators and LECs is to encourage use of the network at economic prices. The New York approach is intended to do this. Clearly each LEC and each competitor will have a different business strategy. Not all will be interested in providing the same services in all territories or all services in a single territory.

But all competitors should have the option to offer any single service in any territory if consumers are to be given the greatest number of choices. Therefore, we need to find a way to induce interconnection for specific services regardless of whether a LEC itself wants to provide the same service. Otherwise, LECs will delay offering services in order to gain a strategic or tactical market advantage over potential competitors.

LIGHTLY REGULATED SERVICES

New York has over the years been anticipatory in trying to grant the necessary leeway to allow competition to bring its benefits to consumers. Thus we were ahead of the FCC in setting conditions under which a local exchange carrier would connect customer owned equipment, and as far back as 1979 we approved flexible pricing plans for station sets for New York Tel and Rochester Tel. In keeping with this approach, we have established a regime of light regulation for resellers, cellular companies, and other common carriers. While treating AT&T Comm more like a land-line carrier than these competitors, we have also lightened our oversight of that company.

Resellers, including shared tenant services, are exempt from rate of return regulation. They are required to file tariffs, but this may be done on short notice, and the price charged may float between the

tariffed maximum and minimum levels. These tariffs are not reviewed by the commission for their relationship to costs. These companies are also exempt from reporting requirements and other administrative procedures that are unnecessary if rate of return is not regulated. To date, AT&T Comm has been rate of return regulated, while the OCCs and special companies have not been. However, the Commission will shortly consider a proposed rate stability stipulation by which AT&T would achieve a flexible regulated rate of return. AT&T Comm is already permitted flexible pricing within a band.

Full deregulation for competitors in the interlata toll-type market may be considered following completion of the generic competition case. However, it is a fact that there are locations within New York that are served by only one interlata carrier, and that Manhattan and two or three major upstate cities are the only locations that attract the attention of several toll-type providers.

In Manhattan, of course, competition for intracity service is apparently quite vigorous, being served by private lines of the local exchange carriers and competitors like Teleport and Manhattan Cable. But the actual extent of it has yet to be documented, and the conditions under which it would grow or expand remain to be specified.

CONCLUSION

We have many tools at our disposal for managing the mixed bag. If we use them creatively, and create commonalities of interest for captive ratepayers and providers of communications service, we can, most likely, gain many if not all of the benefits that perfect competition would provide, without risking the harm that will be assured when a dominant service provider controls the most durable, most lucrative, markets. In New York we are prepared to regulate more lightly. We are not prepared to forego the opportunity to induce more and better service for residential and business customers.

[1]Defining the scope of New York Telephone Company's natural monopoly is one of the objectives of Case 29469, proceeding on Motion of the New York Public Service Commission to Review Regulatory Policies for Segments of the Telecommunications Industry Subject to Competition, initiated Oct. 26, 1986. This is a critical proceeding, because it is the first opportunity the companies have that is independent of rate cases to document either the existence of competition or the conditions--price, client, geography--under which one might expect it to develop.

[2] ATT Comm and other common carriers providing interlata toll service, and OCCs and resellers providing intralata toll service, are also regulated lightly. (AT&T Comm has never requested the Commission to permit it to provide intralata toll).

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STATE REGULATORY STRATEGIES
Chair: V. Louise McCarren

Bailey M. Geeslin: The Information Age - Leader or Follower?

The advancement of technology, significant governmental decisions and the entry of competition in the telecommunications industry has fostered a whole new era of choices for customers and opportunities for service providers.

We believe that these changes will lead to a future of continued high quality, reliable communications and information age services that will benefit all society, from individual households to the largest corporations.

However, traditional rate base rate of return regulation is not compatible with these fundamental marketplace changes and needs. In order for established carriers to compete effectively and bring information age services to all customers, changes in the structures of economic regulation are required. Without such changes, this nation may become a second-rate information based society.

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